INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statement	3
Argument	7
Conclusion	14

CITATIONS

Cases:

Ballagh v. *United States*, 331 F. 2d 874, certiorari denied, 379 U.S. 887	11
Becker v. *Commissioner*, 277 F. 2d 146	13
Bridges v. *Commissioner*, 325 F. 2d 180	11
Broome v. *United States*, 179 F. Supp. 613	13
Dooley v. *Commissioner*, 332 F. 2d 463	12
Fabreeka Products Co. v. *Commissioner*, 294 F. 2d 876	11, 12
Gerstell v. *Commissioner*, 319 F. 2d 131	13
Goodstein v. *Commissioner*, 267 F. 2d 127	13
Jockmus v. *United States*, 335 F. 2d 23	12
Kaye v. *Commissioner*, 287 F. 2d 40	13
Knetsch v. *United States*, 364 U.S. 361	7, 8, 10, 11, 14
Lewis v. *Commissioner*, 328 F. 2d 634	12
Lynch v. *Commissioner*, 273 F. 2d 867	13
MacRae v. *Commissioner*, 294 F. 2d 56, certiorari denied, 368 U.S. 955	13
Nichols v. *Commissioner*, 314 F. 2d 337	13
Rubin v. *United States*, 304 F. 2d 766	13
Sonnabend v. *Commissioner*, 267 F. 2d 319	13
Stanton v. *Commissioner*, 34 T.C. 1	10, 12
Williams v. *Commissioner*, 323 F. 2d 656	12

Statute:

Internal Revenue Code of 1954, Sec. 163 (26 U.S.C. 163)	2, 7

241-214—66——1

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 728

KAPEL GOLDSTEIN AND TILLIE GOLDSTEIN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MAX BARNETT AND ESTHER BARNETT, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

MICHAEL J. IPPOLITO AND AGNES IPPOLITO, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinions of the Tax Court in *Goldstein* (App. 25a–64a), *Barnett* (App. 1a–40a), and *Ippolito* (App. 1a–10a) are respectively reported at 44 T.C. 284, 44 T.C. 261, and T.C. Memo, No.

1965–167. The respective opinions of the court of appeals (*Goldstein* App. 65a–80a; *Barnett* App. 41a–43a; *Ippolito* App. 11a–14a) are reported at 364 F. 2d 734, 364 F. 2d 742 (*per curiam*), and 364 F. 2d 744.

JURISDICTION

The judgments of the court of appeals were entered on July 22, 1966. On October 20, 1966, Mr. Justice Harlan extended the time for the filing of the petition for a writ of certiorari to and including November 3, 1966. The petition for a writ of certiorari was filed on October 27, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Near the end of the tax years in which petitioners won very large taxable prizes (between $50,000 and $140,000), they purported to purchase substantial amounts of Treasury obligations, borrowing the full purchase price and pledging the Treasury obligations on the loans. Petitioners prepaid large amounts of interest in advance and took immediate tax deductions for these amounts, which offset a substantial portion of their fortuitous income. See 1954 Code § 163. Since petitioners were paying a higher rate of interest on the loans than they were earning on the Treasury obligations, there was no reasonable chance that they would profit from the transactions aside from the tax deductions. Subsequently the Treasury obligations were sold and the loans were satisfied out of the proceeds. The question presented is whether the court of appeals correctly denied petitioners' claimed deductions for the prepaid interest.

STATEMENT

The three cases consolidated in the petition for a writ of certiorari have a common pattern. Petitioners[1] fortuitously acquired considerable sums of money in a single year which increased their family income well above its usual annual level. Two of the petitioners won more than $135,000 in the Irish Sweepstakes, and the third won a $50,000 prize in a newspaper contest. Each petitioner, just before the close of the particular taxable year in which he or she had won the prize, purported to borrow hundreds of thousands of dollars to invest in government bonds (which were pledged as collateral for the loans), and to make large cash outlays as prepayments of interest. Each petitioner then claimed these large prepayments of interest as deductions to offset their unusually high earnings that year. The Commissioner disallowed those claimed deductions. (*Barnett* App. 42a–43a; *Ippolito* App. 12a–13a; *Goldstein* App. 66a–68a.)

The following is a brief outline of the transactions and the decisions of the courts below.

1. *The Barnett case.* In 1957 Max Barnett won a $50,000 taxable prize in a newspaper contest. In December of that year he purported to purchase at approximately par from Gibraltar Financial Corporation (Gibraltar) $750,000 par value United States Treasury certificates, bearing interest at 3¾ percent, due on December 1, 1958. Barnett executed a promissory note payable to Gibraltar for the full purchase

[1] The three petitioners' spouses are parties to the suit solely because joint returns were filed.

price, due nine months thereafter, bearing interest at the rate of at least 5½ percent. Barnett gave Gibraltar a check for $30,850 in prepayment of the entire nine months' "interest."[2] The Treasury certificates were pledged as security for the "loan." (*Barnett* App. 8a–10a.)

Gibraltar, however, had neither $750,000 of Treasury certificates nor cash with which to purchase them. It therefore purchased the certificates at a price slightly less than it had charged Barnett, had them, delivered to a bank, Cleveland Trust, which paid for them, and Gibraltar gave the bank a promissory note for the purchase price bearing interest at 4%. (*Id.*, 5a–10a.)

In January 1958, without further consultation with Barnett, Gibraltar purported to repurchase the certificates from him, and to immediately resell them. Gibraltar credited Barnett's account with slightly less than the sales price. The transactions were thus completed within 30 days after they had begun and Barnett received a rebate of approximately 8/9 of the "interest" he had paid in December 1957. Taking into account a small amount supposedly representing short-term gain on the sale of the certificates and interest earned on them, Barnett sustained an out-of-pocket loss on the deal of $139. (*Id.*, 11a–15a, 20a.)

The Tax Court found that Barnett never acquired control over the certificates, and that the transactions with Gibraltar were sham (*Id.*, 23a–24a). Gibraltar,

[2] Barnett also gave Gibraltar approximately $9,000 margin which was later returned (*Barnett* App., pp. 8a, 19a).

for a fee, merely provided "the color and form for petitioner's claim for a deduction for alleged interest" (*id.*, 33a). The Tax Court further determined "that no profit [to Barnett] from a differential in interest rates or appreciated value could have been realized," and noted that Barnett had not shown any possibility of economic gain. "[T]here was nothing of substance to be realized by petitioner from the transaction in question without regard for and except for the tax deduction." (*Id.*, 34a) The Tax Court therefore upheld the Commissioner's disallowance of the interest deduction claimed for 1957, and the court of appeals affirmed (*id.*, 41a–43a).

2. *The Ippolito case.* In 1955 petitioner Ippolito collected over $138,000 as a winner of the Irish Sweepstakes. In December of that year he entered into the same types of transactions with Gibraltar as did Barnett (Compare Pet. 25–27 with Pet. 22–24). As with Barnett, the transactions came to an end within 30 days. Ippolito suffered an out-of-pocket loss of approximately $4,400, and claimed a deduction for prepaid interest of some $37,000. The Tax Court again upheld the Commissioner's disallowance of the deduction, and the court of appeals affirmed on the same grounds as in the *Barnett* case. (*Ippolito* App. 12a–14a.)

3. *The Goldstein case.* Petitioner Goldstein and her husband, who was retired, had an average annual income of less than $1,000. In 1958 she won over $140,000 in the Irish Sweepstakes. In December 1958 she purported to borrow $945,000 from two banks and

to purchase, at a discount, $1,000,000 par value Treasury notes bearing interest at 1½ percent, due to mature on October 1, 1961. The Treasury notes were pledged as collateral for the loans. She paid the banks $81,000 as a prepayment of more than 1½ years interest on the bank loans.[3] By June 1960, at the latest, the transactions had terminated with a net economic loss to petitioner of approximately $25,000. (*Goldstein* App. 33a–36a, 38a–39a, 67a–68a, 73a.)

The lower courts concluded that petitioner entered into the transactions "without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction in 1958 (*id.*, 76a). Calculations made by her son, who was an accountant, at the time the transactions were planned, indicated that there would be an economic loss on the transactions in excess of $18,500. Mrs. Goldstein was paying 4 percent interest on the bank loans while earning approximately 2 percent interest on the Treasury notes and a modest gain when they were sold. (As the maturity date approached, the notes' market value moved toward par, thus creating a slight gain to augment the low interest yield.) (*Id.*, 72a–73a).[4]

---

[3] She also paid a fee of $6,500 to her tax and investment advisors (*Goldstein* App. 75a).

[4] At trial, petitioner sought to establish that it was possible to have made a small profit. The supporting exhibits were not credited by the Tax Court. The court of appeals noted, *inter alia*, that the exhibits showed a profit only as a result of the failure to include all outlays made by Mrs. Goldstein, and that the calculations were also premised on an unreasonably high capital appreciation. (*Id.*, 74a–76a.)

Mrs. Goldstein could have secured an economic gain on the

The Tax Court held that the transactions were lacking in substance, and were shams as payments of interest. The court of appeals rejected the "sham" label because petitioner's transactions were regular in form and it believed that there was insufficient evidence to establish that the banks had intended to create only the facade of a loan (*id.*, 69a–71a), but affirmed the decision of the Tax Court on the ground that the Code did not permit a deduction for interest on loan arrangements "that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences" and which are thus motivated solely by tax avoidance (*id.*, 77a, 79a).

ARGUMENT

The decisions below are correct, and there is no conflict of decisions or other reason for further review.

1 (a). *The Goldstein case.* The court of appeals, although unwilling to refer to Mrs. Goldstein's transactions as shams, correctly held that her prepayment of interest did not qualify for a deduction under 1954 Code § 163. The interdependent loan transactions and Treasury note purchases did not meet the test for the allowance of an interest deduction stated in *Knetsch* v.

---

transactions only if, at the time the loans came due, the Treasury notes were selling considerably in excess of par value (*id.*, 54a–55a). This was highly unlikely. The notes were scheduled to mature in 1961 and bore interest at the rate of only 1½ percent. Thus anyone who purchased them at more than par in 1959 or 1960 would receive less than 1½ percent effective return on his money and also suffer a loss at maturity.

United States, 364 U.S. 361. Petitioner's complex transactions "did 'not appreciably affect [her] beneficial interest except to reduce [her] tax' " and "it is patent that there was nothing of substance to be realized [by her] from this transaction beyond a tax deduction." 364 U.S. at 366. In December 1958 she paid in excess of $87,000 in interest and fees. No reasonable appreciation in the value of the Treasury 1½ percent notes together with the interest they would produce could return more than her 1958 outlays, even if the notes were held for the entire period of the bank loans. Petitioner's massive loans could be explained on no rational commercial basis, other than as a patent effort to obtain a large interest deduction in 1958, with its anticipated effect of reducing the tax liability on her sweepstakes winnings.

Petitioner argues, however, that the court below erroneously took into account her tax avoidance motivation, and that the decision was therefore a misapplication of *Knetsch* (Pet. 18–19). This is not so. Judge Waterman's opinion for the court explicitly stated that (*Goldstein* App. 77a):

> We hold * * * that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have *purpose, substance,* or *utility* apart from their anticipated tax consequences. [Emphasis added.]

The court thus spoke of economic realities rather than motivation. To be sure, the opinion also discussed motive, but only if first "it *objectively appears*

that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit" (*Goldstein* App. 79a, emphasis added). The court below stated that the interest deduction must be allowed (1) if there is substance to the loan transaction, irrespective of motive, or (2) if borrowing has utility, although selected as a means of financing because of its tax effects, or (3) if an intention to obtain a tax deduction is mixed with other motives (*Goldstein* App. 78a).[5] This outline of the factors necessary to meet the requirements of § 163, while general in scope, trenches on no proper loan transactions. It is essentially a restatement of the core of the *Knetsch* ruling—that a transaction, to support an interest deduction, must have some measure of independent significance apart from beneficial tax effects. The principal difference is that the instant opinion would allow a deduction when a transaction does not comply with objective standards yet

[5] Judge Waterman's opinion stated (*ibid.*):

> * * * Section 163(a) shsould be construed to permit the deductibility of interest when a taxpayer has borrowed funds and incurred an obligation to pay interest in order to engage in what with reason can be termed purposive activity, even though he decided to borrow in order to gain an interest deduction rather than to finance the activity in some other way. In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction. * * *

the taxpayer had actually believed that there was a real possibility of economic benefit (*i.e.*, the transaction was prompted by mixed motives and not motivated solely by tax avoidance). See *Stanton* v. *Commissioner*, 34 T.C. 1. The soundness of this supplement to the *Knetsch* principles is not raised by this case, since petitioner failed to prove that she had any non-tax-avoidance motivation. Thus, the decision below cannot seriously be said to be in conflict with *Knetsch*.

We believe, moreover, that the Second Circuit's application of the *Knetsch* approach was unquestionably appropriate in the context of this case. The bank loans and petitioner's purchases of Treasury notes were mutually dependent in that neither could have occurred but for the other; so long as petitioner held the Treasury notes, they would be pledged to secure the loans (except in the "wholly unlikely" event that petitioner could or would pay the principal amount of the debt[*] (see *Knetsch*, *supra*, at 366, fn. 3)). The two categories of transactions were thus inseparably linked, and it follows that they must be viewed together. Like *Knetsch*, which involved a single-premium annuity coupled with a loan, petitioner's Treasury notes tied to the bank loans had at least the potentiality for self-cancellation. That alone warranted an inquiry into the effect of the transactions, if any, on petitioner's beneficial interest. And it is plain that petitioner in fact stood to realize nothing

[*] Mrs. Goldstein did not have the funds to pay the debt, nor did she have sufficient assets or personal credit to raise $900,000 to $1,000,000. (See *Goldstein* App. 67a.)

of substance from the loan and Treasury note transactions beyond a tax deduction.

(b). There is no conflict of decisions. The Fourth Circuit, in a similar "interest deduction" scheme denied a claimed deduction. *Bridges* v. *Commissioner*, 325 F. 2d 180. Although the Fourth Circuit called the Transactions shams, it is clear that both the Second and Fourth Circuits applied the reasoning of the *Knetsch* decision to the type of dealings in issue before them. See also *Ballagh* v. *United States*, 331 F. 2d 874 (Ct. Cl.), certiorari denied, 379 U.S. 887, and the numerous cases cited, *infra*, pp. 12–13.

Petitioner argues that *Fabreeka Products Co.* v. *Commissioner*, 294 F. 2d 876 (C.A. 1), is in conflict "in controlling principle" with the decision below (Pet. 16). In *Fabreeka* the taxpayer (a corporation) purchased, at a premium, bonds which were callable on 30 days notice with the intention of holding the bonds for 30 days, deducting the premium paid under § 171 of the 1954 Code, and distributing the bonds as a dividend to its shareholders. The court concluded that the taxpayer had actually purchased the bonds and that during "the necessary holding period [it] incurred fully all the risks of ownership, both that the bonds might decline in value, a real risk, as [the taxpayer in a related case] learned to his cost, and the possibilities that during that time they might be called." 294 F. 2d at 878. Unlike the present case, the corporation's purchase and ownership of the bonds did not lack substance under objective standards, and motive was therefore immaterial. Moreover, § 171 of the 1954 Code, with which the court was concerned in *Fabreeka*, provides a carefully drawn and detailed

formula for determining the amount of and the time for taking a deduction for bond premium,[7] whereas the interest deduction provision here in question (§ 163(a)) is more general in nature. Thus *Fabreeka* is far removed from the present case.[8]

2. *The Barnett and Ippolito cases.* As the two courts below noted, the Barnett and Ippolito dealings were even more obviously controlled by *Knetsch* than were Mrs. Goldstein's transactions. Not only were the loans to Barnett and Ippolito entirely without economic reality, but they were transparently prearranged with Gibraltar merely to add color to the large interest deductions. The Second Circuit felt it was correct to call the transactions shams, and decisions of the courts of appeals and the Court of Claims have consistently denied recognition to these patent types of simulated business loans. See *Jockmus* v. *United States,* 335 F. 2d 23 (C.A. 2); *Dooley* v. *Commissioner,* 332 F. 2d 463 (C.A. 7); *Lewis* v. *Commissioner,* 328 F. 2d 634 (C.A. 7); *Williams* v. *Commissioner,* 323 F. 2d

[7] Congress has subsequently amended the Code formula to prevent the abuse dealt with in *Fabreeka* by providing that bond premiums shall be amortizable to the maturity date and not to an earlier call date unless the earlier date results in a smaller amortizable premium. § 171(b)(1)(B)(ii).

[8] Petitioner argues that the present decision leaves *Stanton* v. *Commissioner,* 34 T.C. 1, in doubt (Pet. 21). Nevertheless, *Stanton* differs from the present case because there the taxpayer's "Treasury notes transactions would have been profitable before taxes, if events had happened as he anticipated they would at the time of entering into the transactions." 34 T.C. at 8. Here the evidence established both that petitioner had no such belief and also that any appreciable profit was impossible under objective standards (*Goldstein* App. 72a–77a).

656 (C.A. 9); *Gerstell* v. *Commissioner,* 319 F. 2d 131 (C.A. 3) (*per curiam*); *Nichols* v. *Commissioner,* 314 F. 2d 337 (C.A. 5); *Rubin* v. *United States,* 304 F. 2d 766 (C.A. 7); *MacRae* v. *Commissioner,* 294 F. 2d 56 (C.A. 9), certiorari denied, 368 U.S. 955; *Kaye* v. *Commissioner,* 287 F. 2d 40 (C.A. 9); *Becker* v. *Commissioner,* 277 F. 2d 146 (C.A. 2); *Lynch* v. *Commissioner,* 273 F. 2d 867 (C.A. 2); *Sonnabend* v. *Commissioner,* 267 F. 2d 319 (C.A. 1); *Goodstein* v. *Commissioner,* 267 F. 2d 127 (C.A. 1); *Broome* v. *United States,* 170 F. Supp. 613 (Ct. Cl.).

Petitioners' prepayments of "interest", followed in short order by rebates, were supported by neither an actual investment nor the creation of a genuine indebtedness. The government securities supposedly purchased by petitioners were originally delivered to a bank for Gibraltar's account and in exchange for its promissory notes. Gibraltar purported to resell them to petitioners. Less than 30 days later Gibraltar, as shown in its bookkeeping entries, purported to "repurchase" the securities from Barnett and Ippolito at prices below current market price. Those "repurchases" were not the products of any bargaining or consultation. Rather, they were accomplished without prior notice to petitioners, and the record is silent as to Gibraltar's method of unilaterally setting the "repurchase prices." Petitioners' alleged ownership and pledge of the securities as collateral for the "loans" was therefore manifested solely in Gibraltar's bookkeeping entries; they exercised no dominion over that property, nor did they

derive benefit from its purchase and sale. (*Barnett* App. 12a, 13a–15a; *Ippolito* App. 5a.)

The rapid and unsupervised turnover of the securities also demonstrated that Barnett and Ippolito knew at the outset that their "loans" would exist only for a short span of time. Nevertheless, they purported to prepay interest to cover periods relatively far into the future. Gibraltar was essentially a conduit to hold the "prepaid interest" on deposit for the few remaining days of one taxable year—thus lending credence to petitioners' claims to interest deductions in that year—only to return the money (less a fee for the service) almost immediately after the following year began. The purported purchases and dispositions of the government securities were only the means to give the flavor of reality to the "loans." As this Court said in *Knetsch*, petitioners' small out-of-pocket losses on the transactions were merely a "fee [paid to Gibraltar] for providing the facade of 'loans.'" 364 U.S. at 366.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

THURGOOD MARSHALL,
Solicitor General.

MITCHELL ROGOVIN,
Assistant Attorney General.

DAVID O. WALTER,
MARTIN T. GOLDBLUM,
Attorneys.

DECEMBER 1966.

U.S. GOVERNMENT PRINTING OFFICE: 1966